MANUFACTURERS HANOVER

Economic Report

December 1990

Commentary on Pertinent Economic Issues

On The One Hand...

Irwin L. Kellner
Chief Economist

If the questions I've been getting lately are any guide, the issue no longer is are we in a recession, but rather, how bad will it be, and when will it end? In this regard, the statistics are mixed; some suggest a moderate downturn, while others seem to point to a more serious decline. And then there is that elusive, hard-to-quantify element called psychology. Already battered by the events in the Middle East, and by the turmoil surrounding Washington's latest deficit reduction agreement, confidence levels have plunged in response to widespread declines in employment. Indeed, to many businessmen and consumers who are experiencing this downturn for the first time in their adult memory, it looks like the end of Western Civilization as we know it.

Having warned readers more than three years ago (Economic Report—July 1987) that a recession was looming, recent events should come as no surprise. Indeed, as was pointed out in the previous issue of this Report, today's recession—the ninth of the postwar era—had its origins in the stock market crash of October 1987, and its impact on attitudes, wealth, and real estate. Those who heeded these warnings might have missed making the last few dollars in profits—but are undoubtedly better prepared to weather today's economic storm because they didn't overexpand, overhire, overbuy, or overborrow.

Of course, this is small consolation for those who, for one reason or another, got caught up in the current maelstrom and are wondering what comes next. Because this downturn has only recently been recognized, and because it follows in the wake of such developments as a record peacetime expansion, soaring public and private debt, two oil shocks in five years, and an increasingly fragile banking system, it is too soon to determine whether this recession will be mild, average, or deep. What I thought might be useful, however, would be to list the case for a mild versus a deep recession so that readers might have some basis for planning ahead:

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MILD	DEEP
Better inventory management will minimize downtime as producers adjust to slumping sales. Business has been expecting this recession for several years, use of computers to track goods is widespread, as is "just-in-time" controls.	*Inventories don't usually become a problem until after a recession has begun, so current policies and trends offer little guidance for the future.*
Homebuilding has been sliding for the past five years, and must be near rock-bottom. The drop in home prices should soon attract buyers.	*The drop in home prices has affected wealth and confidence to a greater extent than any stock market plunge. What is more, this has left such lenders as banks, insurance companies and pension funds with real estate holdings that are depreciating, thus constraining their ability to make new loans. Finally, the U.S. real estate slump seems to be spreading to other countries, and the corresponding glut of empty buildings will delay the revival in construction spending that usually helps pull the economy out of recession.*

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MILD	DEEP
Speaking of other countries, the lower-valued dollar should help cushion this decline by spurring exports.	*Exports are too small a share of our gross national product to help very much. Furthermore, the drop in the dollar's value has discouraged foreigners from investing in our financial markets, as well as in our companies. They're also turned off by lack of confidence in our economy and in our government, and are increasingly attracted by higher rates back home.*
We entered this recession with much less inflation than we had going into the last two major slumps, so the Federal Reserve should be able to ease sooner and more forcefully to help end it.	*Some Fed members remain concerned over inflation, even though it's largely food and energy, believing that to ease now would be to allow these pressures to spread throughout the economy. They are also concerned about the inflationary implications of the weak dollar. Additionally, lower interest rates might make it easier to borrow—but they will also reduce interest income, on which many households rely.*
At any rate, monetary policy has already eased well before this recession has begun, witness how low our inflation-adjusted interest rates are compared with other industrialized countries. The yield curve is positive, too.	*The yield curve was negative during all of 1989, as the Fed drained reserves from the banking system by the largest amount in postwar history, suggesting that the damage has already been done. Most people are so burdened with debt they might not want to borrow. And the banks, besides lacking sufficient loanable funds, are being increasingly prevented from fulfilling their traditional functions as lenders of last resort by their regulators, who are pressing them to increase their capital ratios, while discouraging them from making certain kinds of loans.*
Small businesses, which were responsible for all of the jobs created in the 1980s and then some, are less likely to be affected by the recession than larger companies.	*But this was precisely because they were able to borrow from the banks; now, many are being denied credit.*
There's plenty of stimulus left in Washington's budget—deficit agreement notwithstanding. First of all, the deficit currently is rising, not falling. Secondly, the announced "cut" of $40 billion for the current fiscal year is less than one percent of GNP—nowhere near the dose of restraint enacted under the Administration of Herbert Hoover, for example. In addition, there'll be less of a drop in defense spending than was scheduled earlier because of events in the Middle East. And there's plenty of public works expenditures still in the pipeline, such as for repairing and rebuilding the nation's infrastructure.	*The fact of the matter is that fiscal policy is not being loosened, as it used to, when it became apparent that a recession had struck. Rather, it is being tightened, and that swing alone will make a difference. Furthermore, the Federal government accounts for 25 percent of the economy today versus only three percent in the 1930s, so any belt-tightening move by Washington is bound to have a greater effect.*

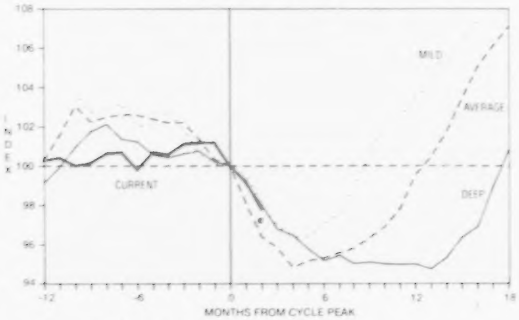
MILD

Most households have more than one person working—and there are many instances where one or more of these family members holds at least two jobs, so the impact of any forseeable rise in unemployment is likely to be less severe than in past recessions. In addition, most people work in the service sector, which is less likely to be affected by a downturn.

DEEP

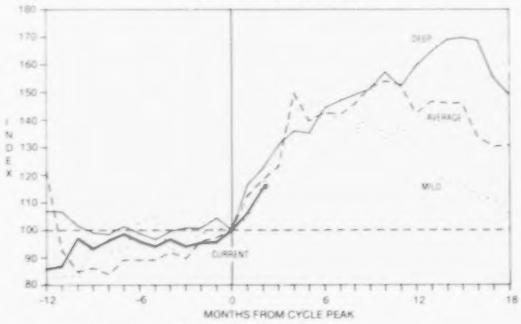
This recession has so far seen unusually large numbers of managerial, professional, technical and clerical support personnel lose their jobs, compared with past declines in economic activity. The crash of 1987 caused many Wall Streeters to lose their jobs. Financial industry employment was also affected by cuts in bank payrolls, while investment bankers lost their positions as the junk bond market contracted. The earlier spate of leveraged buyouts caused many companies to trim staffs, while the slump in real estate is taking its toll among a broad range of white-collar people, from architects, to interior designers, to construction personnel, to brokers.

CHART I
LEADING INDICATORS:
CURRENT EXPERIENCE VS. PREVIOUS 8 CYCLES
(CYCLE PEAK = 100)



Sources: Commerce Department; MH

CHART II
INITIAL UNEMPLOYMENT INSURANCE CLAIMS:
CURRENT EXPERIENCE VS. PREVIOUS 8 CYCLES
(CYCLE PEAK = 100)



Sources: Commerce Department; MH

As you can see, there are good arguments for either extreme. Of course, time will tell which path the economy will take. For the moment, based on a careful perusal of the statistics, and on the assumption that the economy peaked in August, a recession of roughly average dimensions appears to be shaping up (see charts). Since the average recession has lasted about a year, it could mean that bottom will be plumbed by next summer, and that growth will resume well before yearend. If and as this becomes recognized by the public at large, confidence will return and spending will increase.

To ensure this outcome, the monetary authorities should ease significantly; interest rates should be slashed by a point or more, bank reserves should be pumped up, and the regulators should back away and encourage the banks to lend money again. For his part, President Bush needs to convince the American people that he is in control of the situation, and will take steps to alleviate it. He must, however, avoid, such Hooverisms as "prosperity is just around the corner," since people didn't believe it then, and they won't believe it now.

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February 1991

Commentary on Pertinent Economic Issues

Similarities and Differences

Irwin L. Kellner
Chief Economist

Let's face it, business downturns are nothing new. Since the middle of the last century, the United States economy has experienced at least 30 periods in which aggregate economic activity declined enough to cause widespread losses of jobs and businesses. Some were mild, lasting a matter of months, while others were more severe, stretching a couple of years or more. Since these contractions all struck after a period of economic expansion, the contrast was all the more obvious. Not surprisingly, considerable shock and dismay accompanied them.

The current recession is no exception. Although it did not arrive with the suddenness depicted either by the mass media, or by the Administration, there is no denying that America's ninth postwar business downturn is now underway. And because of the many seemingly unusual events surrounding it, more than a few have opined that this recession is more likely to be severe, than mild. Indeed, the most frequently asked question nowadays seems to be what is going to get us out of this slump?

I don't want to belittle the pain and suffering that many are now experiencing, but I would like to suggest that this recession is more similar to its postwar predecessors than it is different. That being the case, the odds would seem to favor a recession that turns out to be no worse than most others we've experienced since the end of the Second World War—and containable by the right economic policy.

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Saddam's Recession?

Those who assert that this is a different kind of recession refer to both its origins, as well as to the way it is developing. With this framework in mind, let us examine how this downturn began. The most common view in and out of Washington is that Iraq's invasion of Kuwait in August turned an economic slowdown into a full-blown recession, as oil prices shot up and confidence plunged. Since the two Mideast crises of the 1970s were also followed by recessions—and these flareups struck during economic booms—such a view is not unreasonable.

The key here, is to go back *before* August 2, when the invasion began. Most of the economy had already been declining. Indeed, as these Reports have been making clear, many industries and regions had been gasping for air for a year or more, under the pressure of a tight monetary policy administered by an inflation-wary Federal Reserve. True, one measure of monetary policy, the level of short-term interest rates, had been falling since the spring of 1989. Thus the Fed might claim that it was actually easing well before the economy stopped growing. However, such quantitative measures of Fed policy as the growth of the money supply, M2, as well as total bank reserves, tell a far different story. Indeed, with bank reserves contracting in 1989 by about the greatest percentage in the entire postwar era, and money growth sluggish, at best, it seems more likely that interest rates fell because the Fed *let* them—not because it tried to *push* them down as part of a policy of aggressive monetary ease.

The next question is why was the Fed so tight? Two reasons come to mind. One, of course, is its ongoing fear of inflation. The other, less commonly known explanation involves policy errors. Let's examine the inflation arguments, first. Back at the end of 1986, thanks to the earlier plunge in the price of oil, the U.S. enjoyed its lowest rate of inflation in over 20 years. Consumer prices wound up rising only one percent, year over year, while several other price indexes registered actual declines! But oil prices had started to climb by the middle of that year, and growth in the gross national product rebounded from the energy-induced drop in 1986's second quarter. Gold and other precious metals' prices had begun to climb, fueled by a sharp jump in industrial raw materials' prices as the goods-producing sector responded to the decline in the value of the dollar against the currencies of our major trading partners.

The net result was that both short- and long-term interest rates hit bottom in late 1986 and began to climb substantially during the first three quarters of 1987. Short rates rose faster than longs, causing the yield curve to flatten by 1988—and become negative in 1989 for the first time since the last recession. After rising in early 1987 by the largest percentage in postwar history, total bank reserves, as observed above, fell two years later—by a near record percentage.

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Tight Money Stifled Growth

This unprecedented monetary tightening, along with some inadvertent help from fiscal policy, set the stage for the slowdown in economic activity that was in progress *before* the Persian Gulf crisis began. Higher interest rates had already suffocated sales of autos and housing in early 1987, and eventually took their toll on the stock market, in the form of the maxi-crash of 1987, and the mini-crash of 1989. Fiscal policy, mainly the Tax Reform Act of 1986, contributed by distorting spending patterns at the end of 1986—not to mention by discouraging investment in real estate from 1987 forward.

What was happening to the rate of inflation throughout this period? By some measures, such as the consumer price index, it rebounded—but only to where it was in 1984. By others (the so-called "core", or underlying rate of inflation excluding the often-volatile food and energy sectors), it continued to drift lower. And while prices of industrial raw materials (which exclude food, energy and precious metals), climbed until early 1989, they're now some 12 percent lower.

However, even at the consumer level, price inflation was less than it appeared. At midyear 1990, most of the rise in goods prices had ceased; whatever inflation remained was largely in services—mainly education and medical care (Economic Report—August 1990). Thus one policy error was that the Fed continued to focus on reducing inflation long after that part of inflation which could easily be dampened by Fed policy was checked. But there were others as well. As the dollar plunged from February 1985 through summer 1986, the Fed evidently must have expected this decline to lead to a pickup in inflation, since by its measure, the dollar had fallen over 30 percent in 18 months. Such a drop in the value of the dollar could be expected to lead to inflation in two ways: (1) by making imports costlier, thus providing domestic manufacturers with an opportunity to hike their selling prices, and (2) by making exports cheaper, thus boosting demand for U.S.-made goods overseas, thereby tightening up our domestic economy.

Inflation Fears Were Exaggerated

All this might have been true—had the dollar fallen by as much as the Fed thought. But while the dollar did decline this much, it did so only against the industrial countries' currencies. Against a broader measure, which includes the currencies of the developing countries of Southeast Asia and Latin America—such as is contained in the Manufacturers Hanover Trade-Weighted Dollar, introduced in September 1986—the dollar had actually fallen by less than five percent. This would seem to be a more accurate measure of the dollar's international value than the Fed's, since the industrial countries' share of our two-way trade had been declining for most of the 1980s. The proof of this is the failure of our trade gap to drop in the face of the dollar's plunge as calculated by the Fed. In turn, this would suggest that the inflation threat from a declining dollar was not as great as it appeared.

Looking back, it's not difficult to understand the Fed's unusual concern over inflation. Alan Greenspan replaced Paul Volcker as Chairman of the Fed in the summer of 1987. Because he was a well-known Republican confidant, he probably felt that he had to overcome the markets' fear that his selection was aimed at ensuring the Republicans' election chances in 1988, so he kept money tighter than Mr. Volcker would have, in order to establish his credentials as a genuine inflation-fighter (Economic Report—July 1987).

A respected private economist and inveterate numbers-watcher, Mr. Greenspan undoubtedly was aware of the underlying weakness in the U.S. economy as he tried to guide it toward a "soft landing"; ie: slowing growth to the point where price pressures are dissipated—yet not to the point where the expansion stops altogether and a recession begins. That, in itself, was risky, but when combined with a fiscal policy whose budget deficit was widening—thus working against the objectives of monetary policy—instead of shrinking, it became a practical impossibility, exposing the U.S. economy to an external shock, such as the Mideast crisis. Indeed, concern over the potential inflationary effects of the widening budget deficit also kept the Fed from easing as much as the economy needed.

Complicating the Fed's strategy was the rise of the so-called money market economists. These analysts tend to focus mainly on the daily course of events, rarely stepping back to see the forest for the trees. Ever since the Fed announced money supply growth targets back in the mid-1970s, these people have been looking over the central bank's shoulder to make sure it

was not capitulating to the forces of inflation. As recently as ten months ago (Economic Report—April 1990), these market economists were exhorting the Fed to *tighten* money on the basis of what was then a rapid rise in employment. This was a completely misleading way to look at the labor situation, as I pointed out then, but, unfortunately, the Fed had been taking its cues from the markets, instead of the other way around, so it was reluctant to ease more aggressively.

Policy Miscalculations

If these factors weren't enough, add two more. The first deals with the way the Fed implements monetary policy. As observed in the August 1989 Economic Report, prior to 1983, the Fed focused on nonborrowed reserves in the banking system as its main control instrument. Its aim was to achieve a rate of money supply growth consistent with its usual objective of sustainable economic growth and price stability. But financial innovation and deregulation weakened the link between money and the economy, so the Fed shifted to a borrowed reserves-based operating procedure.

The Fed reasoned that, rather than go back to pure interest rate targeting, it would attempt to gauge market pressures by the degree to which member banks would borrow from its discount window in response to a widening or a narrowing of the gap between the discount rate and the Federal funds rate. Bank borrowings used to correlate with the change in this gap, but from early 1988 on they failed to do so. This was not a sign that the Fed wasn't tight enough—as the Fed thought was the case—but rather, it reflected several developments, among them the switch in 1984 to biweekly reserve maintenance periods, fears of recession inducing the banks to curtail lending and the need to improve capital ratios, leading to the same result. Thus the Fed wound up being tighter than it had intended—witness the drop in total bank reserves referred to earlier.

The other factor involves the Fed's role as a regulator of the banking system. As noted above, the commercial banks have been under pressure to improve their capital ratios. There are, of course, a number of ways to accomplish this, but in today's economic and investment environment, the approach most often used is to cut back on new lending. This is one of the reasons cited for today's so-called "credit crunch".

Thus, from here, at any rate, it would appear that this recession's origins were, in the final analysis not all that different from those past. It was for the most part brought on by a restrictive monetary policy, reacting to, among other factors, what seemed to be signs of rising inflation. Those who say that the economy was not expanding too rapidly just prior to the downturn ignore the fact that it was—several years earlier. The prolonged period of monetary tightening, plus the two stock market crashes, help explain why such usual "pre-recession" signs as a buildup of inventories, rapid economic growth, high capacity use, and a surge in prices, wages and jobs, were largely absent a month or two before the slowdown turned into an actual recession.

As for the way it is developing, it has both ordinary as well as unusual characteristics. On the ordinary side, attitudes have soured, leading people to postpone purchasing big-ticket items, vacations, eating out, etc. Businessmen have reacted by tightening their corporate belts, slashing payrolls, advertising and other promotional expenses, while delaying any plans to modernize or expand. As these developments have cut into tax revenues, state and local governments have been forced to raise taxes and/or lay off workers—further depressing their economies.

Unusual Developments

On the unusual side, because this recession was so long in coming—not to mention expected here for some three years—it seems to be "front-loaded." That is, the bulk of the bad news is coming at the beginning, rather than at the end. Aware that a recession was nigh, many businessmen cut orders, reduced their inventories, and slashed their payrolls at the first sign of slower sales. Ironically, this could help keep the recession's toll down, since adjustments that normally aren't made until later will help keep downtime to a minimum, and could even lead to an early pickup in new hiring.

Another unusual aspect of this recession is that it seems to be affecting occupations that in the past were barely touched. I'm referring, of course, to such "white-collar" positions as managers, professionals, technical and clerical

support personnel. In particular, lawyers, accountants, media people, commercial and investment bankers, stockbrokers, and real estate people including architects, interior designers and construction personnel have not only lost jobs en masse—they've also had significant difficulty finding new positions in their professions.

Of course, this follows another unusual development—the decline in real estate values in many parts of the country. As explained before, some of this might be a byproduct of the Tax Reform Act of 1986, which suddenly changed the rules for investing in real estate. Thanks in part to the 1981 tax law, real estate had been a sought-after investment, pushing up its value perhaps faster than might otherwise have been the case. Soaring stock prices from 1982-1987 gave real estate a further shove. But except for those who might have purchased a home or other piece of property during the past few years, most are still sitting on real estate worth more than they paid for it. The credit crunch might be making it difficult for some to buy and/or to develop property, but this will change once growth resumes.

Recommendations

There's nothing so odd about this downturn that it can't be rectified by policymakers. The Fed, for one, needs to remember that its primary objective is to ensure a stable financial system in order to foster a sound economy and sustainable economic growth. Inflation will never totally go away in a dynamic, free-market economy such as ours—especially when such external factors as the weather and wars can affect prices of such vital commodities as food and energy. Thus the Fed needs to cut interest rates further by aggressively injecting reserves into the banking system, thereby restoring needed liquidity.

On the fiscal side, Congress ought take another look at the tax laws to see if the changes made back in 1986 in the interests of tax equality have, in the process, served to stifle economic growth by reducing the incentives to invest—especially in real estate. For his part, the President needs to wind up the Middle East war as soon as possible, then turn his attention back to our domestic economy and demonstrate that he can work with the Congress as effectively at home as he has abroad.

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April 1991

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Next: Victory At Home

Irwin L. Kellner
Chief Economist

The speed and manner in which the American forces and their coalition allies won the Persian Gulf War has produced a significant change in the mood of individuals and businessmen all around the United States. The difference is palpable. It is reflected in the joyous homecoming celebrations, the parades, and in the ubiquitous American flags and yellow ribbons tied around trees, automobile antennas—and even lighthouses. These express feelings Americans have about themselves and their country that haven't been seen since the end of the Second World War.

If the past is any guide, these high spirits should soon translate into higher rates of spending. For example, in 1946, the first full year following the end of World War II, spending by consumers rose over ten percent in real terms, paced by a 66 percent jump in durable goods, as the lifting of wartime controls enabled Detroit to begin producing and selling cars once again. Business responded with a 16 percent increase in outlays for equipment, and a near-doubling in spending for structures. Exports shot up, too. The net result was a hefty 32 percent increase in private real gross national product.

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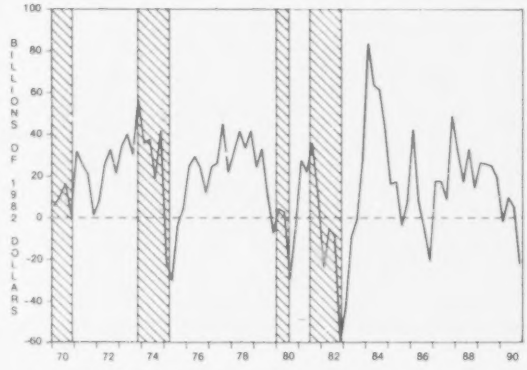
The end of the Korean and Vietnam Wars also led to greater private-sector spending—although not on the scale which came after World War II. This is because wartime needs in these two cases did not constrain the private economy the way they did in the 1940s, when controls were clamped on both spending and output. And while the direct effect of the Persian Gulf War on output and spending was virtually non-existent (except, of course, for those who were sent over to fight) because the military hardware had already been produced and stockpiled, its ending, by removing a cloud of uncertainty and lifting people's collective spirits, should nonetheless put consumers and businessmen in a spending frame of mind.

You can see it in the various surveys of the public's mood. The Conference Board says that in February—even while the war was still ongoing—confidence rose by the most for any month in three years. Early reports for March suggest an even bigger jump took place, following the war's end. The business mood has brightened, too. A new survey by Dun & Bradstreet shows that its Industrial Sentiment Index increased sharply in February compared with January, with expectations for the months immediately ahead at their highest since last summer.

The Recession Is Winding Down

Does this mean that America's ninth postwar recession is now over? Not quite. The war did not by itself cause the U.S. economy to turn down; other factors played a part—and they are still present. There is no doubt, however, that the invasion of Kuwait by Iraq last August did exacerbate the downward tendencies that were very much in evidence last summer (Economic Report—August 1990), so the end of the Persian Gulf crisis should provide at least some lift. When added to a number of other positive developments, it should lead to an end to this recession within a few months.

CHART I
REAL CHANGE IN BUSINESS INVENTORIES



Source: Commerce Department

One key reason for expecting economic activity to pick up soon is the state of business inventories. Usually they continue to rise after a recession has begun, as producers learn too late that sales have turned down. By the time production levels are trimmed below the pace of shipments, many months have gone by. This time, business stepped on the brakes quickly—so quickly, in fact, that inventories fell in 1990's fourth quarter, even though sales were still rising (Chart I). And shelves were half empty to

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begin with, thanks to widespread caution, use of computers, and "just-in-time" methods of inventory control.

While this haste to slash stockpiles depressed output quickly, it could lead to an equally as rapid upturn. This is because production must be raised to the level of sales, once desired inventory levels are reached—and if sales should be rising, however slightly, the rise in output schedules would have to be even faster. Of course, this would lead to greater demand for materials, supplies and labor, boosting sales, profits and incomes in the process.

This income growth, coupled with the sharp drop in prices of gasoline and heating oil back to the levels that prevailed last summer, before the invasion, will help translate these gains in consumer confidence into increased spending. And let's not forget the returning troops, many of whom are reservists who remained on their employers' payrolls while they were overseas—earning combat pay, exempt from taxes. They've got the confidence, the buying power—and the pent-up needs to add a lot to the spending totals.

Another plus stems from the value of the dollar. Although it has increased from its recent lows, it is still generally regarded as undervalued against the currencies of Western Europe. This alone has boosted exports, leading to our first trade surplus with these nations since 1982. The rebuilding of Kuwait will add further to exports, especially of construction, machinery and equipment, autos, communication facilities, etc.

Domestically, the war has already affected defense spending. Instead of declining as it was programmed to do, following the relaxation of tensions between the U.S. and the U.S.S.R., defense spending has kept rising. This uptrend is likely to continue for a while—if only because the war has reminded policymakers of the need to maintain a strong defense. This means a number of things, from keeping military pay scales high enough to attract people to the volunteer armed forces, to more research and development to ensure that our planes and missiles continue to have the technological edge that was crucial to winning Desert Storm.

In looking ahead, it is always useful to look back—in this case, to the behavior of the financial markets. Both stocks and bonds have rallied in recent months, adding significantly to household wealth. Bond prices were ten percent higher at the middle of last month than they were last August, as interest rates on the bellwether 30-year Treasury bond fell from 9.10 percent to 8.25 percent. For their part, stock prices have jumped by over 25 percent since early October—18 percentage points of which have come since the middle of January. This kind of rise in stock prices has never failed to signal the onset of an economic recovery within a few months.

Some Hopeful Signs

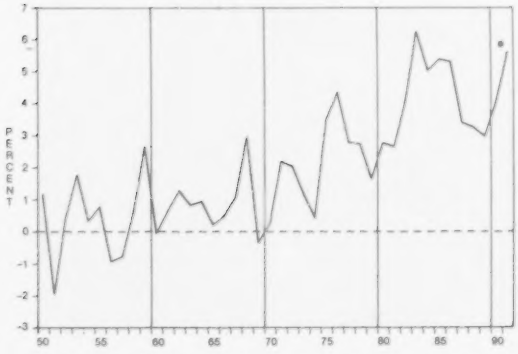
To be sure, there are a number of signs which already point to a winding down of the ongoing recession. These are faint, and could easily be reversed, should some unexpected development occur. But there are enough of them so that taken together, they point to an earlier—rather than a later—end to the recession:

- Industrial raw materials futures prices stopped falling in January, and have since moved five percent higher;
- The Purchasing Managers' Index of Industrial activity rose in February—the first monthly increase since last May;
- Manhours worked rose in February, as did payroll incomes;
- February saw a three percent jump in department store sales, after a rise of 0.6 percent in January, while new car sales have stabilized, so far this year;
- Fixed-rate mortgages, at 9¼ percent, are now at a four-year low. Combined with a drop in housing prices, it means that the average family is closer to affording a home than at anytime in the past decade;
- The money supply has begun to rise, reflecting increased lending activity by the banking system, on the heels of an easing by the Federal Reserve.

Although it was too tight for too long, there is no denying that the Fed moved to counter the decline in economic activity, once its magnitude became clear. In recent months, it added re-

serves to the banking system, dropping certain reserve requirements, while allowing the key Federal funds rate to fall 2½ points. In addition, it has cautioned bank examiners against overzealousness in pursuit of their tasks, while urging the banks to shed their reluctance to lend. And while nonborrowed reserves have risen sharply since the end of October, the Fed has recently begun encouraging the banks to borrow from its discount window to ensure the ready availability of loanable funds.

CHART II
REPORTED* FEDERAL BUDGET DEFICIT
AS A PERCENT OF GNP



e=OMB estimates includes S & L Bailout *Net of Trust Fund purchases
Sources: Treasury Department; Commerce Department; MH

Those who feel that these easing moves by the Fed are insufficient to jump-start the economy in the absence of assistance from fiscal policy would do well to remember three things: (1) Washington's budget deficit *is* growing; in the current fiscal year the gap will probably exceed $300 billion, up from $220 billion in FY 1990; (2) Even if it were the same as last year's, it would represent around four percent of GNP—one of the highest shares since the end of World War II (Chart II); (3) As we saw in 1982, once the Fed loosens up and makes enough money available, budget deficits become stimulative, for Washington can borrow without crowding out the private sector.

Maintaining Growth May Be Tough

With all three levers that control economic activity—monetary and fiscal policy and the value of the dollar in foreign exchange markets—now in the wide open position, not to mention the end of the war and the rise in the stock and bond markets, it is not too difficult to envision this recession ending within a few months. However, just like keeping the peace in the Middle East may well prove to be tougher than winning the war, so maintaining the economic recovery that is expected to get underway later this year might turn out to be harder than extricating the economy from recession. This is because, as noted earlier, many of the factors that gave rise to this recession are still very much around. They include:

- *The Tax Reform Act of 1986*, which, by changing the rules of investing, depressed real estate values and contributed to the weakening of the banking industry;
- *The higher capital gains tax*, which has also turned out to be a disincentive for investment;
- *Consumer tax burdens*, which have been increased by the elimination of the deductions for sales taxes as well as for interest expense on most types of loans—not to mention through sharp jumps in Social Security taxes, along with those on alcohol, tobacco, gasoline, and "luxuries."
- *Tightened regulatory standards* regarding bank capital ratios and the loan examination process, which continue to inhibit bank lending;
- *Debt loads* which remain high for both business and consumers;
- *Overbuilding* of commercial and residential buildings, which effectively precludes the increase in construction activity that usually helps boost the economy out of recession.

If these were not enough, there is the upward pressure on longer-term interest rates that may already be underway because of sizable governmental borrowing needs. Besides Washington, the governments of Kuwait, Saudi Arabia, Germany and Japan will be—or already are—tapping the markets for funds. At some point this could discourage long-term borrowing by the private sector, and could even put the kibosh on rising equities' prices. In this environment, one has to hope that the Fed will not reverse course, and tighten up at the first sign of economic growth, thinking it means renewed inflation. ■

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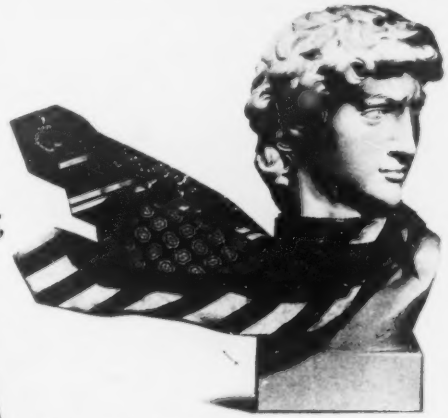

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Economic Report

June 1991

Commentary on Pertinent Economic Issues

Irwin L. Kellner
Chief Economist

Manufacturers Hanover Economics Department 17/270

The Worst Is Over

Not long ago, the National Bureau of Economic Research, the official arbiter of the business cycle, determined that America's ninth postwar recession got underway last August. If it continued through the end of last month, it would be ten months long—no worse than six of its eight postwar predecessors, as far as length is concerned. It is milder than average in most other respects as well. For there are a growing number of signs which suggest that the worst may be over, and that our tenth postwar expansion may be close at hand.

As usual, there are some who would dispute the view that the end of Western Civilization as we know it has once again been postponed. By and large, they tend to be those people who are experiencing economic uncertainty for the first time in their adult memory. And there are many of them, in view of the length of the expansion which preceded this recession. By setting the business cycle peak as last July, the NBER declared that the 1982-90 expansion lasted a whopping 92 months. This was far and away the longest uninterrupted stretch of growth for the U.S. economy in peacetime. It was more than twice as long as the postwar average—and was second only to the 106-month expansion that included the Vietnam War.

Darkest Before Dawn

Among the naysayers are those nabobs of negativism from the business community. A recent meeting of the prestigious Business Council found most corporate executives in strong disagreement with their economists, who are forecasting an early end to this recession. You can't blame many businessmen, I suppose, in view of their own dreary circumstances. Government figures show that new orders for durable goods topped out last autumn, and by March were running a hefty 15 percent below their peaks. Unfilled orders, consequently, have fallen two percent—and are down even more, if you take out transportation equipment, mainly aircraft, which takes a long time to build.

Speaking of transportation, anyone remotely connected with the automobile industry can't be a happy camper, these days. New domestic car sales in April and May ran at the lowest rate in 8½ years—when the economy was in the last recession. A number of factors have been blamed for this seeming lack of buying interest in new cars, but the most important, it seems to me, is the question of affordability.

For over ten years, the automakers have been boosting car prices faster than the increase in their customers' incomes. In 1980, the typical car cost the equivalent of 18 weeks of the average family's income; by last year it was nearly 24 weeks—and this is with more jobs per family! To offset this, car buyers have been encouraged to borrow for longer periods to enable them to bring their monthly payments back into line with their incomes—but this has had the effect of keeping people out of the market for a new car that much longer.

With autos chugging along in low gear, it would be tough to jump-start the economy even under the best of circumstances. But this is far from an ideal gestation period to bring forth an economic recovery because another key industry, construction, is languishing as well. The building boom of the 1980s has combined with the downsizing of business staffing needs of the 1990s to produce a glut of vacant space. The office vacancy rate today is more than 17 percent compared with only four percent ten years ago, while nearly 23 percent of factory space is currently unused, versus 15 percent 2¼ years ago. Many regions also report excess space in shopping centers, warehouses, and hotels. To make matters worse, even where there might be an opportunity to develop a piece of property, financing is very difficult to come by, as lenders try to cope with the two-way squeeze caused by the Tax Reform Act of 1986 (which depressed real estate values), and tightened regulatory standards regarding bank capital ratios and the loan examination process (which has inhibited lending).

When consumers look around, they are not thrilled, either. While various surveys of people's moods show a nice rise in confidence from January's 16-year low, it is mostly due to rosier expectations for the future—not because of any sudden improvement in their current financial situation. Payroll employment is down by 1⅔

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million from its high point last June, the number of reported jobless is up by nearly 26 percent, while the unemployment rate in March hit its highest point in 4½ years. Because a larger than usual number of unemployed have come from the better-paid, white-collar ranks, personal incomes adjusted for inflation in the first eight months of this recession alone were down by more than in any previous full-term recession in the past 38 years except for the 1973-75 downturn, which in many respects was the worst since the 1930s.

Years of trying to keep up with rising prices and higher taxes have depleted many families' savings, causing them to go heavily into debt. The savings rate has fallen to one of its lowest levels in the postwar era, while people owe more, relative to their take-home pay, than they ever have before. It hasn't helped matters that the value of the average family's biggest asset—its home—has fallen significantly over the past three years.

On the other hand, the drop in home prices has also produced buying interest. Sales of both new and existing one-family homes bottomed out in January, seasonally adjusted, while housing starts are well above their January lows. People are evidently responding to what they rightly believe are the best buys in quite some time. Based on a ratio of average selling prices to family incomes alone, new-home affordability is the greatest it's been in at least three years; include today's lower mortgage rates and the comparison stretches back to the early 1980s.

Help From Housing

This pickup in housing activity should not be underestimated, when it comes to helping the economy emerge from a recession. Sales of new houses, of course, will increase the demand for all kinds of materials that go into the construction of a home—not to mention for the skilled labor necessary to build the house. This adds to business and employee earnings, as you can imagine, even before a family moves in. Once it does, it usually furnishes, so additional spending on furniture, fixtures, home appliances, wallpaper and carpeting or flooring takes place. These latter expenditures will also occur when an existing home is purchased, although maybe at a slower pace, since this kind of home has already been furnished. Regardless, home sales do get people back into the buying habit, and once consumers have returned to the stores, it doesn't take much to trigger additional spending, such as on electronics, apparel, etc.

The latest figures show this may already be underway. Retail sales at general merchandisers have risen three percent in the past four months, after falling 2¾ percent during the preceding four. In April, merchants selling building materials, garden supplies and housewares reported a healthy 3½ percent jump in sales, while furniture and other home equipment posted an increase of nearly two percent. Retailers of apparel saw their sales rise by over two percent, while restaurants rung up a half-point gain.

If consumers keep their wallets open, merchants and other businessmen will soon find it necessary to stop trimming their staffs, and start adding. At the manufacturing level, this may already have begun. The factory workweek—a leading indicator of future hiring activity—turned up in April after three consecutive months of decline, while payroll employment fell at a much slower pace than the average of the previous six months. New claims for unemployment benefits were 100,000 fewer at the start of last month than they were in late March, while the percentage of nonfarm industries adding jobs in April was the highest in more than six months. As long as these trends continue, both real incomes and people's confidence in their current situation will start rising, reinforcing the upturn in retail sales, thus in aggregate economic activity.

The nation's purchasing managers already sniff improvement in the air. Their index covering the industrial side of the economy hit bottom in January, and has been rising ever since. It has finally showed up in the output of the nation's factories, mines and utilities, which rose in April, after falling nonstop during the previous six months. In particular, gains were reported in business equipment and in goods for export. Nevertheless, production schedules are being kept below the pace of sales, since business inventories are still sliding.

Keeping inventories lean is a good idea when sales are soft and financing is hard to come by. But sales have firmed, suggesting some re-stocking might be necessary. This, of course, would probably involve an increase in financing, which should now be more available, given the recent increase in bank reserves and in the money supply as part of the Federal Reserve's efforts to resuscitate the economy. The Fed is currently pumping out reserves at the fastest pace in four years, while the money supply is expanding by the most in a year. Since business demand for short-term credit remains weak, this had led to a 2½ point drop in the Federal funds rate since last summer alone, allowing the banks to bring their prime lending rates down to the lowest level in three years.

June 1991
MH FORECAST OF GROSS NATIONAL PRODUCT
(Seasonally Adjusted Annual Rates)
In $ Billions

	< Actual						Projected >					
	1990				YEAR 1990		1991				YEAR 1991	
	1	2	3	4	LEVEL	% CH	1	2	3	4	LEVEL	% CH
Gross National Product	5375.4	5443.3	5514.6	5527.3	5465.1	5.1	5562.3	5597.0	5658.9	5716.9	5633.7	3.1
GNP: $82	4150.6	4155.1	4170.0	4153.4	4157.3	1.0	4123.9	4119.1	4135.6	4154.7	4133.3	–0.6
% Change, Annual Rates	1.7	0.4	1.4	–1.6	1.0		–2.8	–0.5	1.6	1.9	–0.6	
Consumption $82	2677.3	2678.8	2696.8	2673.6	2681.6	0.9	2664.1	2669.8	2681.3	2699.0	2678.5	–0.1
Durables $82	437.6	426.8	429.5	415.6	427.4	–0.1	403.9	401.1	403.2	407.7	403.9	–5.5
Non-Durables $82	915.6	911.2	916.4	901.2	911.1	–1.0	894.6	900.0	904.9	912.8	903.1	–0.9
Services $82	1324.2	1340.9	1350.8	1356.7	1343.2	2.6	1365.5	1368.7	1373.3	1378.5	1371.5	2.1
Investment $82	700.7	700.7	697.0	656.3	688.7	–3.9	630.1	629.3	632.0	634.7	631.5	–8.3
Non-Residential $82	514.6	508.4	519.3	519.4	515.4	1.8	499.6	483.1	477.9	473.9	483.6	–6.2
Producers Durable Equip. $82	390.8	387.5	397.0	403.1	394.6	2.8	386.5	376.7	375.4	373.9	378.1	–4.2
Structures $82	123.8	120.9	122.4	116.4	120.9	–1.2	113.0	106.4	102.5	100.1	105.5	–12.7
Residential $82	188.3	182.8	173.0	163.3	176.8	–5.4	151.2	151.6	153.0	152.7	152.1	–14.0
Inventory Changes $82	–2.2	9.5	4.7	–26.4	–3.6		–20.7	–5.4	1.1	8.1	–4.2	
Net Exports $82	–35.4	–44.6	–46.5	–8.8	–33.8		2.2	–7.6	–8.8	–9.7	–6.0	
Exports $82	628.1	620.1	630.5	647.2	631.5	6.4	646.5	642.0	639.9	640.0	642.1	1.7
Imports $82	663.5	664.7	677.0	656.0	665.3	2.8	644.3	649.6	648.6	649.6	648.0	–2.6
Government Purchases $82	807.9	820.2	822.7	832.3	820.8	2.8	827.5	827.6	831.1	830.6	829.2	1.0
Federal Defense $82	254.4	256.5	258.2	265.7	258.7	0.9	265.2	267.4	270.8	270.2	268.4	3.7
Federal Civilian $82	78.6	89.4	87.8	84.2	85.0	8.1	81.6	80.2	80.2	80.1	80.5	–5.2
State & Local $82	475.0	474.3	476.7	482.4	477.1	3.0	480.7	480.0	480.0	480.3	480.3	0.7
Final Sales: $82	4152.8	4145.6	4165.3	4179.8	4169.9	1.6	4144.6	4124.5	4134.5	4146.5	4137.5	–0.6
% Change, Annual Rates	3.8	–0.7	1.9	1.4	1.6		–3.3	–1.9	1.0	1.2	–0.6	
Domestic Demand: $82	4186.0	4199.7	4216.5	4162.2	4191.1	0.5	4121.7	4126.7	4144.4	4164.4	4139.3	–1.2
% Change, Annual Rates	0.5	1.3	1.6	–5.1	0.5		–3.8	0.5	1.7	1.9	–1.2	
GNP Price Index (1982 = 100)	129.5	131.0	132.2	133.1	131.5	4.1	134.9	135.9	136.8	137.6	136.3	3.7
% Change, Annual Rates	4.8	4.7	3.7	2.8	4.1		5.5	2.9	2.8	2.3	3.7	
Consumer Price Index (82-84 = 100)	128.2	129.4	131.6	133.8	130.7	5.4	135.0	136.2	137.2	138.2	136.6	4.5
% Change, Annual Rates	7.5	3.8	6.9	7.0	5.4		3.5	3.7	3.0	2.9	4.5	
Total Personal Income	4562.8	4622.2	4678.5	4718.5	4645.5	6.0	4735.2	4742.8	4784.3	4833.5	4773.9	2.8
Disposable Personal Income	3887.7	3925.7	3969.1	4001.9	3946.1	5.9	4016.9	4023.7	4056.8	4096.5	4048.5	2.6
Savings Rate	4.9	5.0	4.2	4.2	4.6		4.1	3.5	3.2	3.0	3.5	
Unemployment Rate	5.3	5.3	5.6	5.9	5.5		6.5	7.0	7.2	7.2	7.0	
Indus. Production (1987 = 100)	108.3	109.4	110.4	108.5	109.2	1.0	105.9	104.6	104.8	105.7	105.2	–3.6
Housing Starts (000)	1454.3	1203.7	1130.7	1042.3	1207.8	–12.9	913.7	984.8	1016.2	1116.4	1007.8	–16.6
Domestic Auto Sales (000)	7014.7	6798.0	7211.3	6590.0	6903.5	–2.6	6150.0	5807.4	6064.4	6198.5	6055.1	–12.3
Corporate Pre-Tax Profits	296.9	299.3	318.5	304.1	304.7	–1.0	290.5*	295.0	305.0	315.0	301.4	-1.1
Net Profits	167.1	166.1	179.4	177.6	172.5	0.0	169.7*	172.3	178.2	184.0	176.1	2.1

*MH estimate

The stock market senses that better times lie ahead. The decline in interest rates and the expectation that this will lead to better sales and earnings have sent stocks soaring. From their lows of last October, the popular stock averages jumped more than 25 percent by April, before slipping a bit in May. This kind of rise in such a short period of time has never failed to signal the onset of an economic recovery within a few months. There's no mystery behind this; a rising stock market adds to the wealth, hence buying power, of those who invest, and confidence to investors and many others as well. Higher stock prices also enable companies to raise more equity capital, thus giving them more funds to spend, too.

Not surprisingly, the Government's index of leading economic indicators climbed in February and March, after falling nonstop during the previous six months. Its track record at predicting a pullout from recession is better than forecasting the onset of a decline, so if this index rises for another month or two, it would be an additional sign that the worst is over.

A Muted Recovery

Accordingly, the table to the left projects another decline in the gross national product adjusted for inflation during the current quarter—but at a much-reduced pace from that of the first. The expected upturn in aggregate economic activity should become visible on a quarterly basis starting in this year's third quarter, with a modest rise in the real GNP. However, to many, it will be difficult to distinguish between recession and recovery for several reasons. First, new jobs will not be readily available, since employers will not want to add to their staffs until they are sure the improvement in business is permanent. Also, learning from recent experience, many will try to keep their payrolls "lean and mean." Second, new peaks in overall spending are not likely to be reached until well into 1992, suggesting the need to keep a close watch on inventories and other costs of doing business, since weak demands will make it difficult for most companies to raise selling prices in order to boost profits.

The muted nature of this recovery contrasts with past rebounds, which have seen the real GNP jump by rates of nearly seven percent during the first year. Regardless of when they believe this recovery will get underway, practically all forecasters agree that it will be much slower than average. This is because, as noted in the April Economic Report, many of the causes of this recession are still present.

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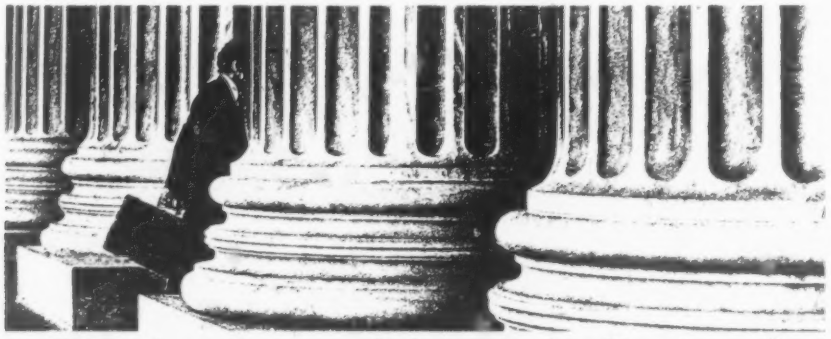

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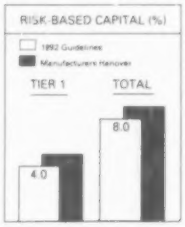

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MANUFACTURERS HANOVER

Economic Report

August 1991

Commentary on Pertinent Economic Issues

The Bumpy Road To Recovery

Irwin L. Kellner
Chief Economist

Although not everyone would agree, there is enough statistical evidence to suggest that America's ninth postwar recession has ended, and that another expansion has begun. One can sympathize with those who feel otherwise, since the pickup in business activity is gradual and localized. At the same time, it is widely recognized that any recovery will carry with it unusually heavy baggage which could drag the economy down again fairly soon. Not surprisingly, a few economists are postulating a "double-dip" scenario—where the gross national product adjusted for inflation falls again, possibly as early as the current quarter.

Before addressing the outlook, a look back at some favorable statistics might be useful:

- The Government's index of coincident economic indicators rose in April, May, and June, after falling during the previous nine months. In the past, such a rise has signalled the end to an ongoing recession.
- Factory output has expanded during each of the past three months—with over 50 percent of the surveyed industries reporting greater production.
- The nation's purchasing agents, confirming this uptrend, report that their index of industrial activity has risen for five months in a row, with June's reading above the critical 50 mark for the first time in over a year.
- Inventories have been trimmed significantly since last year, pointing to further gains in output as long as sales don't falter.
- Nonfarm payrolls rose in May, marking the first month-to-month increase since last June. Meanwhile, the average workweek is rising, along with hourly wages, and there's been a noticeable decline in the number of people losing their jobs since March.
- Consumer confidence has rebounded from its January low point, although many people remain concerned about their present economic situation. As a result, while there has been a pickup in consumer spending, it's been relatively modest.
- New-home construction has jumped nearly 25 percent in the past five months, after sliding 25 percent in the previous five. Sales of both new and existing homes have climbed during this time, suggesting that this increase in construction activity is sustainable.
- Inflation has been subdued, which will keep buying power from being eroded, while holding out the possibility that interest rates will at least hold steady—if not decline further.
- The index of leading economic indicators has risen for five months in a row. In particular, the stock market, as measured by the Standard & Poors 500 Index, rose nearly 30 percent between mid-October and the end of July.

The Pickup Is Uneven

With this much evidence of a pickup in business activity already in hand, one might wonder why there is so much concern over the state of the economy. The answer becomes apparent when one looks beneath the surface of the national scene, and examines specific industries and regions. While the U.S. economy has never moved through business cycles monolithically, the contrasting trends in different sectors have never been as vivid as they are today. This is because of the peculiar nature of the 1990-91 recession.

For one thing, it was not caused by rapid inflation and rising interest rates which would tend to curtail spending on such big-ticket items as new cars and houses, leading to the brunt of the contraction being felt by America's industrial heartland. Rather, it was a byproduct of the drop in real estate values and bank lending that followed in the wake of the Tax Reform Act of 1986, stricter examination standards, and higher capital requirements. Two stock market crashes and a sudden end to the frenzied deal activity that characterized most of the 1980s were factors as well.

The net result was that the brunt of the drop in business activity took place in the Northeast. Especially hard hit were those people who worked in the financial services industry (banking, stockbrokers, investment bankers and their support staffs) real estate (developers, brokers, architects, interior designers and construction

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personnel), and those industries which depend on spending from these groups, such as merchants of upscale goods, ad agencies, the print and electronic media, and more recently, lawyers and accountants.

The contrast is all the more vivid when one recalls that the Northeast was one of the fastest growing regions of the United States during the 1980s, thanks to the boom in the financial services sector which boosted the economies of New York State and surrounding areas, and the surge in technology-related industries, which bolstered most of the New England states. Accompanying these uptrends was a frenetic pace of construction, both commercial and residential, and a sharp rise in real estate values.

Many States Are In Trouble

Some states in this region, as well as those in other parts of the country, took the opportunity afforded by their booming economies to expand their spending programs. They were able to do this even though the flow of aid from Washington (revenue sharing) began to slow as the Federal government grappled with a burgeoning budget deficit. Indeed, many *had* to spend more, since Washington was passing laws ordering more social spending at the state and local level—even as it was cutting back aid to these governments. As a result, state and local budgets ballooned as did the number of employees on their payrolls.

While any economic downturn affects tax revenues flowing to Washington, it hits state and local governments harder. This is because they depend not just on income tax receipts—but also on revenues from sales and property taxes. And, as noted above, these sources were especially hard hit in the Northeast. With mandated programs, if anything, still on the rise, and payrolls continuing to grow, it should not be surprising that many states and local governments have suddenly found their own budgets deeply in the red. Unlike the Federal government, states and local governments cannot run deficits in their budgets for very long. The net result: Many are now cutting spending, laying off workers and raising taxes. This is bad news for those directly affected by these actions; it's also one of the extra pieces of baggage that the nascent recovery will have to bear, since in the past, states and local governments usually aided an economic upturn by *increasing* spending.

Speaking of governments, Washington won't be of much help, either. True, the Federal deficit will probably reach a record level in dollar terms during the government's fiscal year which ends September 30; it will be even higher next year. Relative to GNP, these deficits would rank among the largest since the end of the Second World War. However, much of this red ink has resulted either from the lack of tax revenues characteristic of any recession, plus, this time, spending to fund the Resolution Trust Corporation's "bailout" of the failed savings and loans. Unlike past recessions, there has been no tax cut and/or deliberate expansion of Federal spending to help boost economic activity out of recession.

Bring Back The Punch Bowl

On the monetary front, the best that can be said about Federal Reserve policy is that it is not as tight as it was from 1988 through last summer. However, it is not very accommodative, either. The money supply continues to grow very slowly, in part because of the reluctance of the banks to lend and business to borrow, but also because the Fed continues to be parsimonious, when it comes to injecting reserves into the banking system. It may be true that short-term rates, over which the Fed exerts direct control, have come down nearly five percentage points since the spring of 1989. It is also a fact that, in "real" terms, adjusted for inflation, these rates are now down to their postwar average. But given the weakness in loan demand, some would say that rates have fallen because the Fed has *let* them fall—not because the Fed actively pushed them down. At any rate, the central bank's obsession with higher capital ratios, coupled with the continued strictness by various bank examiners, suggests that even lower rates and faster money growth might be more appropriate in the present economic/regulatory setting.

This lack of access to bank financing in the aftermath of the debt binge of the 1980s has kept the rate of business casualties extremely high. It is not hard to imagine the drag this puts on an economic recovery. For one thing, it reduces landlords' rental incomes, as stores and offices remain vacant. This, in turn, pushes further into the future the day when construction activity will revive and do its part to boost economic activity. For another, it cuts suppliers' sales revenues. It also means fewer job opportunities. And, of course, it deprives governments on all levels of revenues from various taxes, with all the implications imaginable.

One of the factors that kept the recession mild may not be of much further help—at least for a

while. Exports held up nicely during the 1990-91 downturn, thanks to the earlier weakness in the dollar compared with the currencies of our major trading partners. Indeed, between the end of February 1985 and the end of February of this year, the dollar had declined by nearly 50 percent against the industrial countries' currencies alone. This made our goods cheaper to other countries' importers, while boosting the cost of the merchandise they sent to us. Thus our trade position on the GNP basis went from a deficit of over $140 billion back in 1986, to an actual surplus in the first quarter of this year, when adjusted for inflation. Needless to say, this provided an important prop under domestic activity by giving U.S. businesses an opportunity to keep their assembly lines rolling even after local demand had softened.

But the dollar has stopped falling and has risen over ten percent since February. If this is accompanied by a softening in the economies of our major trading partners, then exports will probably stop growing, and may even decline. When added to the pickup in imports that usually follows a strengthening in domestic business activity, it constitutes one more reason to be concerned about the staying power of any economic upswing.

That's assuming there is a pickup in domestic spending. For the consumer, who accounts for one out of every three dollars that make up the GNP through purchases of goods, may not be in much of a position to spend—at least for a while. As is commonly known, savings are low and debts are high. At 3.7 percent of take-home pay, the savings rate in this recession was 2.3 points below the average of the previous eight postwar recessions—and the lowest since the 3.4 percent recorded in the 1948-49 downturn. By contrast, people were saving over eight percent of their incomes during the 1973-75 recession. That's one of the reasons the ensuing recovery was strong and long-lasting.

At the same time, consumers' debt burdens have never been higher. As against an average of 12.5 percent of disposable incomes, and a previous high of 16.4 percent in the 1980 recession, installment debt alone as a share of take home pay reached almost 19 percent earlier this year. Obviously this constrains people's borrowing power, thus their ability to lift their spending until their incomes improve. This is unfortunate, since incomes were unusually hard hit during this recession, in part because relatively more people from higher income brackets lost their jobs, and also because of people's greater reliance on interest income than in past cycles. At any rate, the apparent mildness of this past recession points to fewer pent-up demands than was the case following other, deeper recessions.

Finally, as has been noted in these Reports many times during the past few months, the fundamental causes for the 1990-91 recession are still present. These include the Tax Reform Act of 1986 (which depressed real estate values), along with tightened regulatory standards regarding bank capital ratios and the loan examination process (which has inhibited lending). Until these regulatory drags abate, the recovery will limp along, encumbered by what has been universally recognized as a "credit crunch."

Double Dip Doubtful

Having said all this, is it reasonable to expect a double-dip recession, or, merely, a slow but steady economic recovery? Those who feel a double dip lies in our future are, of course, cognizant of the weaknesses noted above. However, they also point out that five out of the last eight recessions saw the GNP rise after one or two quarters of decline—only to fall back once again, thereby prolonging the downturn. Their use of history to predict the future is not out of line—but if they looked at the full story behind the previous double dips, they would see that it bears little relevance to the current situation.

Past double dips have traced to either or both of the following two developments: (1) an early tightening by the Fed and (2) business moves to cut inventories. As far as the first item is concerned, the Fed, as noted earlier, never really became aggressively easy during the past recession, so it is unlikely to have to tighten anytime soon. In addition, and possibly because of the Fed's relatively snug stance, the rate of inflation has cooled; consumer prices rose at an annual rate of just three percent in this year's second quarter, while producer prices climbed only half as fast, and most raw materials' tags were actually falling. As for inventories, they were liquidated even before the recession began, leading to a rather unusual decline in inventory-sales ratios during the recession.

Thus the best bet remains a slow but steady upswing in economic activity—one that will keep the jobless rate from falling as fast as it usually does and sales and earnings from rising as fast as they usually do—but one that, by keeping wage and price pressures at bay, may well turn out to have greater staying power than is now generally anticipated. ■

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Economic Report

October 1991

Commentary on Pertinent Economic Issues

We Never Promised A Rose Garden

Irwin L. Kellner
Chief Economist

Pity those economists who sit at their screens all day, scrutinizing the minute-by-minute minutia of the financial markets. They tend to immerse themselves so much in the ebb and flow of the data that they literally are unable to see the forest for the trees. Some of them work for bond houses; they seemingly never met a statistic they liked. For you see, bearish economic numbers tend to lift bond prices since they imply lower interest rates, and these economists in particular must feel a need to help their firms sell bonds.

If this were not enough, consider the industry most economists work in, and the region in which they are located. I'm referring to the financial services industry and the Northeast—both of which have been hit harder than usual during the recent recession. But there is life west and south of the Pennsylvania border. Indeed, conditions in the Northeast notwithstanding, there is persuasive evidence of a slow but steady economic recovery building up. Let me bring you up to date:

- Business sales are now up for four straight months, the first such increase since 1989;
- Business inventories are now at a two-year low, having fallen for six straight months, the longest such period in 8½ years;
- Industrial production has climbed for five months in a row, the first time that's happened in a year;
- The Purchasing Managers' Index of conditions in the industrial sector has climbed every month since January, and now stands at a three-year high;
- New-home construction, in the form of housing starts, has gone up for five straight months, the first time that's happened since 1980;
- The Government's index of leading economic indicators has risen for six straight months—the most in four years;
- Business payrolls have expanded by 110,000 in the past four months, compared with a drop in 885,000 during the previous four;
- More than half of all reporting industries are now adding to their payrolls—the most since just before the recession began last year—while the weekly number of new claimants for jobless benefits has dropped by over 140,000 from their March peak.

Services Slim Down

These gains in employment may come as a surprise to many who work in financial services in the Northeast. And with good reason: 14 months after total employment reached a peak, jobs in what the Labor Department calls F.I.R.E. (Finance, Insurance and Real Estate) are down 0.7 percent. By contrast, employment in this category continued to grow during the same period surrounding all eight previous postwar recessions. Needless to say, the Northeast has a disproportionate number of workers in the financial services industry.

Other service categories have also been hard hit. Government employment, for one, has fallen 1.2 percent during the past 14 months—the second largest decline for this point in the business cycle, and only the third such drop during the entire postwar era. Total service payrolls are down 0.4 percent, the most since the 0.6 percent drop recorded during the period surrounding the 1957-58 recession. Further cuts are in store, according to a recent survey by the American Management Association, which also reports that corporate downsizing ran at a record pace during the past year.

To compound matters, many of those who have lost their jobs may be unable to obtain employment in their fields. The Labor Department believes this is most likely to happen to people who are laid off by the Federal government, and by companies in financial services. As a result, many will have to settle for jobs paying less than the ones they lost. This may account for the growing incidence of part-time employment, as people take on a second job in order to bolster their incomes. In addition, the long-run trend towards multiple-worker households continues unabated.

Although these displaced workers might not agree, there are several bright spots in this otherwise gloomy service sector picture. First, fewer workers can result in greater productivity.

Manufacturers Hanover Economics Department 17/270

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Service industries have been lagging in this regard—even though such innovations as personal computers, word processors, desk-top publishing with laser-jet printing, fax machines and new telecommunications systems have become commonplace. In turn, this will help keep labor costs down—especially important in this labor-intensive sector. Corporate profitability will benefit from this—and this is also important in today's environment, where making a sale can be tough and boosting prices can be even harder. And, of course, this means that the progress made in slowing inflation will continue. Less inflation will help keep interest rates down, thereby ensuring that the nascent recovery will not come to an untimely end.

Since four-fifths of the workforce is in the service sector, this murky job outlook has understandably depressed the attitudes and buying plans of a great many families. The Northeast's nabobs of negativism point to this, along with negligible income growth, a low savings rate and record debt loads as reasons not to expect much help from the consumer in the coming months. And if consumer spending, which, as everyone must know by now, accounts for two-thirds of the gross national product, fails to rise, the ripple effects on the rest of the economy would be hard to overcome and a new (or continuation of the old) recession would occur.

Goods Growth Gives A Lift

Not to worry! The gloomsters are overlooking one crucial development—the ongoing improvement in the goods-producing sector of the economy. As noted earlier, industrial production is in an unmistakable uptrend. As also pointed out, this is not being accompanied by an increase in unsold goods. Indeed, quite the opposite is taking place: the five-month rise in production has accompanied a six-month drop in inventories! To put in bluntly, producers are not increasing output with the intent of adding to their stockpiles. Rather, they are trying to keep them from being depleted too rapidly.

A couple of conclusions can be drawn at this point. First, manufacturing is as important to the economy today as it's ever been since the end of World War II, so developments in this sector still carry a lot of weight. Second, the ongoing rise in industrial production means factor incomes have gone up as well. In other words—someone has to be making more money, given the rise in output, whether it is the workers who run the assembly lines, their employers or their vendors. Let's not forget those companies that provide the fuels, electricity, machinery and equipment. These firms all pay taxes, so governments at all levels are taking in more money as well.

It doesn't take a rocket scientist to figure out that even at this stage, more money is being earned and/or made available for spending. At some point, these expenditures will necessitate an increase in inventories, since it is awfully hard to sell products that don't exist. As pointed out earlier, business sales have already climbed for four straight months; it is only a matter of time before many companies conclude that more—not less—inventories are needed. For if there's one thing worse than losing sales for lack of buyers, it's losing sales for lack of merchandise.

Before this past recession began, many economists argued that better methods of inventory control would modify—if not prevent—the next recession. They pointed to widespread use of computers and the so-called "just in time" system of inventory management popular in Japan. However, it would appear as though business trimmed its inventories by about as much in this past recession as it did, on average, in previous downturns. This is because relatively few firms actually use the "just in time" method as it is practiced in Japan, since they have not built up the comprehensive network of arrangements with suppliers, shippers, etc., necessary to make this work. In many cases, firms claiming low inventories have either shifted the burden to their suppliers, or to their customers through discounts and other incentives. Thus, when sales get to the point where more inventories are necessary, there could be a rush to rebuild.

In any event, the gains in output have already boosted incomes of factory employees, by enabling them to work longer hours and find more jobs. Surely, this has led to increases in spending by consumers in some parts of the country; retail sales in the Midwest are up 2½ percent compared with a decline of 1½ percent in the rest of the country. It is only a matter of time before they bottom out elsewhere since some service sector hiring will be needed just to keep pace with the rise in goods output and sales.

Also required for economic growth are lower interest rates and more money in circulation. That rates have come down cannot be denied. Over the past two years, the key Federal funds rate has fallen 4½ percentage points, leading to

declines in other short-term rates—including bank lending rates to business, as well as rates consumers pay on home equity loans and other loans whose rates are tied to short-term rates. However, it would seem that these lower rates have done little to spur increased borrowing by either consumers or business, since both consumer credit and business loans outstanding have been shrinking for most of this year. This, of course, implies less spending.

Pushing On A String?

As for the money supply, the widely-followed M2 version has fallen $11.6 billion over the past three months. This has brought its year-to-date growth rate close to the Federal Reserve's minimum objective. Thus a number of observers—including many who would otherwise have an optimistic view on the outlook—have expressed concern not only over the ability of the economy to grow, but also because the Fed seems to be "pushing on a string."

These anxieties are not unfounded. Huge debt loads are keeping many consumers and businessmen from borrowing, while lender caution and regulatory constraints are limiting the amount of funds available. To this must be added the fact that households earn twice as much interest income as they pay in interest expense, and the proportion of personal income derived from interest stands at a near record.

Here, too, all is not bleak. For one thing, with $626 billion of commercial and industrial loans outstanding, lower rates mean lower interest payments for business of as much as $12½ billion, or nearly eight percent of after-tax profits. This frees up a lot of money for spending on new employees, machinery and equipment, and research and development. No matter how much is allocated to each, the net result is more incomes, hence more spending power in the economy. For their part, consumers with adjustable rate mortgages and other loans will find themselves in similar circumstances; more money left to spend (or save) as desired. Those holding bonds as investments must also feel better, since lower rates mean higher bond prices. And for those inclined to buy a home, lower rates obviously make such a purchase more affordable.

The money supply's meager growth is not as problematic as it appears, nor does it necessarily suggest an impotent Fed. The Fed never could directly control the money supply—especially at this stage of the cycle, when it would be seeking to pump it up. This is because the Fed can only directly control its own balance sheet, what some would refer to as the monetary base. The Fed has increased the bank reserves portion of the monetary base quite substantially in recent months. Indeed, the 12-month rise in total bank reserves is now the greatest in four years. But this has not translated directly into M2 money growth for two reasons: (1) Less bank lending, and (2) a flow of funds out of small certificates of deposit.

Let us examine each in detail. As is well known by now, businesses have been borrowing less from their banks. From a high of $648 billion at the end of last year, commercial and industrial loans have fallen $22 billion, or about 3½ percent. Some of this is due to greater lender caution, since this period encompasses most of the past recession. Some also traces to regulatory constraints, such as tightened examination and capital standards. But some can also be attributed to less demand from business since inventories are down. Also, many companies are replacing short-term debt with funds raised in the bond market, now that long-term interest rates have come down as well.

To the extent that some banks have excess reserves, however, they are not lying idle. They are either lent temporarily to those banks who need them, or are invested in U.S. Government obligations. Either way, they remain in the economy, available to be converted into spending. The same is true for the funds that have left the banking system's small-denomination time deposits looking for higher yields elsewhere. They have gone into mutual funds that invest in such higher-yielding instruments as Treasury notes and bonds, "Ginny Maes", corporate bonds and the like. They may not count as M2 money—but they are in the economy just the same.

The current recovery, like the recession that preceded it, has many unusual aspects. As such, like the recession, it has gone unrecognized in its early stages by the cadre of vocal—but not necessarily accurate—economists that sit by their screens watching the markets. Those who are willing to step back and put things in their proper perspective, however, can see that the glass is not half empty, but half full and getting fuller all the time. These are the people who will be prepared to take best advantage of the new business environment now unfolding. ■

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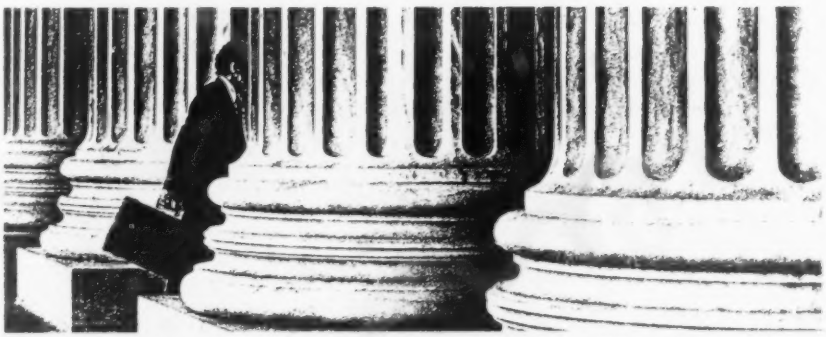

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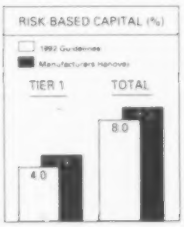

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